Remarks of
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Federal Energy Regulatory Commission

EEI Member Workshop

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Good Afternoon. This EEI Workshop on Incentive Ratemaking provides a good opportunity for me to share with you some of my thoughts on transmission incentives. This is a very timely subject and one that I've been giving considerable thought to for the past several months. In fact, I recently participated in the Aspen Institute's 24th Annual Energy Forum, where I spoke on the need for the Commission to do all it can to encourage the further development of the Nation's transmission system. Today's Workshop is an appropriate forum in which to continue that discussion.

I certainly don't have to tell this group about the tough challenges facing the electric industry. So this afternoon, I want to touch on two of those challenges -- reliable and RTO formation -- and what the Commission can do to address those issues in the context of incentive ratemaking and, in particular, rate of return.

Right now, there is a great deal of concern -- within Congress, the Administration, FERC, the industry and the media -- regarding the reliability and general state of the electric supply and transmission systems in the U.S. In particular, reliability of the transmission system is getting considerable national exposure in the nightly news, talk shows, and articles in major newspapers. The past two summers have shown that we have good reason to be concerned. We have seen price spikes, localized black-outs and tight reserve margins. These same conditions have been forecast for this summer, as well.

But restructuring always comes with a certain degree of complication and unforeseen development. Uncertainty and confusion are not uncommon in an evolving industry. The relative newness of wholesale and retail restructuring is producing uncertainty among consumers, competitive suppliers, and transmission providers. FERC must do all it can to reduce this uncertainty.

With regard to reliability, FERC's role historically has been quite limited. In the past, voluntary reliability standards were developed by the industry and NERC. Compliance with those voluntary standards depended primarily on peer pressure among the utility industry and close scrutiny by Federal and state regulators.

However, legislation just passed in the Senate would change that situation by creating a system in which mandatory reliability standards would be developed and FERC would have a specific oversight role to play in ensuring compliance with the standards. Even though I have stated in testimony before the Senate that I prefer a comprehensive approach to restructuring legislation, I did tell Senator Bingaman, in response to a question at the hearing, that I would support stand-alone reliability legislation because I placed so much importance on this component of our Nation's energy infrastructure. I still agree with that.

FERC is taking steps available to it to address the concerns of the industry and the public. We are looking at short-term and long-term actions to deal with reliability issues. In fact, we recently issued two orders identifying such measures and soliciting comments from the industry on what other actions FERC can and should take.

But, perhaps the most important action that FERC is taking to address reliability concerns is the formation of Regional Transmission Organizations (RTOs). As you know, the Commission's Order No. 2000 requires transmission owning utilities to make RTO filings by October 15. Compliance filings from utilities already in existing ISOs are required by January 15, 2001.

Order 2000 did not mandate RTO participation, but adopted a voluntary approach. In addition, the Rule provided for flexibility as to corporate form and did not establish boundaries. It allows utilities to make proposals that are appropriate for their particular regional circumstances. I continue to believe that this flexible approach is the most prudent way to move forward at this time. I would also like to say that I continue to support the collaborative approach set forth in Order 2000. I am committed to let the process play out as Order 2000 envisioned. However, if the collaborative process does not produce the results that FERC intended, obviously we will have some tough decisions to make.

Order 2000 discussed several benefits that RTOs can offer to address remaining barriers and impediments to competition. Important among those benefits is that RTOs will improve grid efficiencies and reliability. One way that RTOs will help in that regard is by allowing for more efficient regional planning for transmission and generation investments. I think most people would agree that the Nation's transmission system must be enhanced and expanded in order to keep pace with the ever growing energy markets. In Order 2000, we said that RTOs must have the ultimate responsibility for both transmission planning and expansion within their regions.

So what can FERC do to encourage the formation of RTOs, so that the benefits we cited in Order 2000 can be achieved? First and foremost, we must send clear signals that our stated willingness to consider innovative pricing proposals for transmission owners who join RTOs was not a hollow promise. I know that some in the industry are concerned that FERC will not do what it said it would do to encourage utilities to both join RTOs and to build new transmission facilities. Although I can't speak for my colleagues, let me assure you that I will do all I can to make sure the Commission honors its commitment to carefully consider proposals for innovative rate treatments for RTOs and the utilities that join RTOs.

Order 2000 discussed several possible rate treatments that could help spur RTO formation. These include: (1) the use of performance-based rate regulation, such as price incentives and performance standards; (2) allowing a higher return on equity on transmission plant; (3) allowing the transmission owner to retain the benefits of cost savings attributable to RTO formation; (4) acceleration of transmission cost recovery in rates; (5) liberalized allowance of levelized or non-levelized rate methods; and (6) incremental pricing for new transmission investments.

While I will be open to new ideas on these and other innovative rate treatments, I find particularly compelling the Commission's use of return on equity (ROE) policy as an incentive to form RTOs. I believe that a reasonable and adequate return on equity for transmission assets will be a key element in encouraging utilities to join RTOs and to expand the transmission grid. Furthermore, the use of ROE policy entails certain elements that I find attractive from a regulatory standpoint: (1) simplicity; (2) transparency; and (3) effectiveness.

First ROE is relatively simple. Other rate treatments, such as performance-based or levelized rates, may require utilities to file more complex or controversial proposals. An approach using rate of return is relatively easy to understand and uses known formulas.

Next, ROE is transparent. I have been a strong supporter of regulatory approaches that provide transparency to consumers and to the marketplace. The effect on rates of using such measures as levelized rates or accelerated depreciation would probably not be a apparent as simply adjusting the return on equity.

Finally, ROE is effective. Reasonable ROEs will give utilities greater incentive to make the necessary improvements to the transmission grid. Thus, reasonable ROE policies should be effective in enhancing reliability. I also believe that a utility that is allowed to earn a fair and reasonable return on its transmission facilities will be more likely to make the decision to join an RTO.

The Commission needs a return policy that provides sufficient flexibility to adjust ROEs in accordance with risk and policy goals, such as the need for more investment in transmission. The Commission also needs to provide certainty on its ROE policies. Certainty is desired by all stakeholders. Put simply, the Commission's return policy must allow a return on equity sufficient for a utility to attract investment capital. Utilities should be able to realize a return on equity commensurate with returns earned by businesses with comparable risks. And the Commission's risk analysis should factor in both business and financial risks.

I believe there are sustainable reasons for allowing upward flexibility in return for RTO participation. First, there are benefits to consumers in that RTOs will improve the reliability and efficiency of the transmission grid. And because transmission costs do not comprise a large part of the total rate paid, the upward flexibility on return should not have significant rate impacts. Second, the Commission must recognize that RTO participation could increase the financial risk and uncertainty of the transmission business. Finally, with regard to the Commission's policy considerations, it is imperative that RTOs have the incentive to expand the grid and ensure an adequate transmission infrastructure to address constraint and congestion issues. By no means should utilities be penalized for complying with Commission initiatives; and in this instance for joining RTOs.

The general approach that I would advocate in establishing a reasonable ROE policy is for the Commission to be open to sharing demonstrable benefits between consumers and transmission owners. Consumers will benefit, for example, from the numerous advantages of RTOs, including the elimination of pancaked rates, and transmission owners will benefit from a flexible and realistic rate of return policy. In my opinion, this results in a win-win situation.

In closing, let me reiterate that there is a real need for the Commission to send a clear and positive signal to the industry on its return policies. I do believe our return policy is integral to developing reasonable ratemaking treatments for RTOs and will be an important factor in the formation of RTOs and the development of a sufficient transmission infrastructure.